

TACKLING BARRIERS TO ENTRY IN POSTAL SERVICES

Final decisions and recommendations

March 2005

Summary

Purpose of the document

- S.1. Postcomm has already decided to remove the legal barrier to entry in postal services (i.e. Royal Mail's statutory monopoly over items weighing less than 110g). This document sets out Postcomm's decisions on its policy on a number of other barriers to entry to the mails market, identified in the Competitive Market Review proposals document published in September 2004. This document also concludes some issues relating to Royal Mail's special privileges, which were the subject of a consultation document in January 2004.
- S.2. This document does not deal with the question of what products for large business customers and operators comprise Royal Mail's universal service. A decision on the definition of that element of the universal service will be incorporated in the May price control proposals.

Postcomm's vision for the market

- S.3. Postcomm, working in the interests of postal users, is committed to establishing a regulatory framework that facilitates a competitive and innovative postal market. This is central to Postcomm's achieving its vision (in fulfilment of its duties) for the market of:
- "a range of reliable, efficient and innovative postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market".*
- S.4. Postcomm believes that customers' interests will be best served in a market where effective competition offers customers choice and encourages vigorous rivalry, efficiency and innovation on the part of postal operators.
- S.5. Postcomm aims to introduce effective sustainable competition between postal operators, benefiting all customers. This means:
- o a range of credible choices for customers;
 - o a level playing field for competitors with all key barriers to entry addressed;

- no abuse of market power by Royal Mail;
 - real (not just threatened) competition which drives efficiency, cost-reflective pricing, and innovation in products and processes; and
 - competition based on credible long-term business propositions.
- S.6. Postcomm believes that a successful Royal Mail, the UK's only universal service provider, is central to achieving its vision for the market.
- S.7. This document confirms that Postcomm must do more to achieve its vision. Although the breadth of competitive entry so far is encouraging in terms of innovation, it is still only in its formative phase and some key barriers to entry have been identified that may prevent it from becoming effective across a broad section of the market.

Postcomm's approach to assessing competition

- S.8. In common with regulatory best practice, Postcomm believes that there is no unique indicator of competition. Market share is undoubtedly one of the key indicators, and Postcomm will refine its approach to assessing market shares over time as the market develops. However, Postcomm's view is that it should try to use as much evidence and opinion as possible and take a view about the development of competition in the round. Important evidence that will be considered includes entry and innovation to date, market shares and volumes, Royal Mail's performance and behaviour, customer awareness and barriers to entry. Following its September 2004 consultation, Postcomm reaffirms this approach.
- S.9. Postcomm intends to complement this approach by continuing to deepen its relations with customers and operators. Postcomm's Forward Work Plan sets out how it will do this.

Competitive developments so far

- S.10. The market for postal services continues to grow. By Royal Mail's own calculations, its inland letter traffic volumes grew by over 1½% in 2003/4. Royal Mail also expects the market to continue growing by at least 2% per annum for the next year or two. Market segments of strong growth included direct mail and advertising mail. Some segments, such as business-to-business mail communications, have been affected by electronic substitution. However, the internet has proved a valuable growth opportunity for fulfilment of on-line orders. Some operators are developing products and services to extend the value chain (e.g. database management).
- S.11. Since March 2001, Postcomm has issued nine long-term licences to new operators. New entrants have adopted a range of innovative strategies to differentiate their products from Royal Mail's products. UK Mail is primarily offering a two day business class service utilising its pioneering agreement with Royal Mail for third party access to its delivery network. DX Services offers an enhanced document exchange system for business-to-business mail flows among closed user groups. Express Dairies, in partnership with TNT Mail, utilises its network of milkmen to deliver mail to people's doors.
- S.12. Although entry by competitors to Royal Mail has been broad in scope, it has not been particularly "deep" in terms of the volumes handled. The September 2004 proposals showed that competitors operating in the licensed area handled a total volume equivalent to about 0.3% of the regulated market in 2003/04 by revenue. The most recent data suggests this is increasing. During the first three quarters of 2004/5, new entrants carried 0.6% of the licensed market by revenue (or 0.7% by volume). In addition to these volumes, operators such as DX Services have been offering mail services (to closed user groups) for a number of years.

Royal Mail's performance and the universal service

- S.13. Royal Mail, as the established operator with its universal network, offers a full range of services that will deliver mail to every address in the country. It handles over 20 billion items per year, equivalent to 80 million items per day. Its economies of scale generally give it a significant unit cost advantage for letter products.
- S.14. Royal Mail's financial performance has improved considerably over the past couple of years. In 2003/04, it made a profit from operations of £348m (before pension deficit payments and exceptional costs) on its regulated products (equivalent to 6% on turnover). This has been driven by stronger than expected volume growth, price rises afforded under its current price control, and greater control over costs.
- S.15. The (unaudited) interim results of Royal Mail Holdings Group, reported in September 2004, saw group profit from operations grow to £217 million, compared to £55 million the previous year. While this is a slightly different scope of business to that specifically regulated by Postcomm, it shows that the trend is upwards.
- S.16. Although there was significant concern from postal users in 2003/4 about Royal Mail's quality of service, it looks to be improving. After missing all fifteen quality of service targets in 2003/4, Royal Mail appears to be on course to hit some targets this year. More progress is, however, necessary.
- S.17. Royal Mail will complete its Renewal Plan within the next six months, aimed at improving its efficiency and cost effectiveness (one of the major initiatives being to move to a single daily delivery).
- S.18. Finally, Royal Mail now appears to be accepting the introduction of competition and (albeit with some regulatory intervention) has negotiated access agreements with three licensed operators, one mailing house and one customer.

Barriers to entry and steps to encourage competition

- S.19. In its September 2004 proposals, Postcomm identified a number of key barriers to entry, and suggested how best to tackle them. Having carefully reviewed the responses to that and other consultations, Postcomm has reached the following decisions on each.
- (i) Royal Mail's economies of scale
- S.20. Royal Mail's network reaches all residential and commercial addresses in the UK. This gives it a significant unit cost advantage over new entrants in certain activities such as delivery, where high fixed costs are spread over a large volume of items.
- S.21. It is likely that economies of scale exist in other activities. Royal Mail was of the opinion that a high degree of economies of scale exists in collection of mail from residential customers (i.e. through its network of pillar boxes).
- S.22. Postcomm recognises the benefits of Royal Mail's economies of scale to postal users, in terms of keeping unit costs (and hence prices) lower than would otherwise be the case. Postcomm has accordingly facilitated downstream access to Royal Mail's network for other operators. This approach enables competition in marketing, collection, sorting and trunking activities, whilst enabling operators to access Royal Mail's delivery network, in effect sharing the benefits from economies of scale. It should also help operators with longer-term plans for end-to-end networks build up scale in the short to medium term.
- S.23. The present access arrangements are based on bilateral negotiations between Royal Mail and other operators. Postcomm is concerned by some industry sentiment that this effectively gives Royal Mail the opportunity to exercise market power given its unrivalled position. Postcomm recognises the concerns of those that have argued it should get more involved to ensure access is a success. For example, Royal Mail, despite its previous commitments, has not brought forward an access code as envisaged under its licence.
- S.24. Postcomm has decided not to make any changes at this stage to Royal Mail's licence condition governing access. If parties fail to reach an agreement, Postcomm stands ready to make a determination on the matter.

S.25. Postcomm does, however, plan to take the following steps:

- o Price control. Postcomm believes that, in the absence of a suitable code with appropriate regulatory controls, there is a case for bringing access products within the price control from April 2006 when the new arrangements are due to come into effect. Postcomm is considering that possibility and will publish initial proposals for Royal Mail's next price control in May 2005;
- o Transparency of costs. To improve transparency, Postcomm believes that greater accounting separation is needed. Postcomm has decided to require Royal Mail to split its costs into core value chain activities. Royal Mail has accepted this. Details will be set out in Royal Mail's Regulatory Accounts, which are due to be published later this year. In advance of this, Postcomm will also decide whether this information should be independently audited. Postcomm will formalise the licence arrangements as part of the licence modifications that are required for the price control review; and
- o Further work on ring-fencing. Postcomm has decided to confirm its position set out in its September 2004 proposals to monitor the success of the present access and ring-fencing arrangements. Should Postcomm believe that the access regime is being operated in a way which does not further the interests of postal users nor promote effective competition, it may consider alternatives, such as a greater degree of business unit ring-fencing. To help inform this work, Postcomm's Forward Work Plan for 2005/6 contains a project that will assess the relative merits of potential options.

(ii) Royal Mail's VAT exemption

S.26. Royal Mail's VAT exempt status creates a distortion as competitors' offerings to non-VAT recovering customers (such as financial institutions) are at a material competitive disadvantage to Royal Mail. Such customers account for around 50% of Royal Mail's business by value.

- S.27. In addition, Royal Mail is unable to recover around £150 million of (input) VAT that it is itself charged by suppliers. Both factors result in Royal Mail and new entrants operating under different trading conditions.
- S.28. Respondents generally supported Postcomm's analysis that Royal Mail's VAT exemption was a barrier to entry. However, respondents had differing views on the extent to which Royal Mail's VAT exemption foreclosed the market.
- S.29. VAT policy is a matter for Government, not Postcomm. However, the Government has sought Postcomm's advice on the issue. Postcomm reaffirms its recommendation to Government that a solution ought to be found that achieves two principal objectives. First, there should be a level playing field for all postal operators. Second, the solution should not lead to significant price rises for postal users.
- S.30. Postcomm considers that a uniform rate of 5% being applied to postal services is one solution (on the basis that a total exemption is unlikely, albeit acceptable) that is consistent with Postcomm's two principal objectives. Postcomm will continue to pursue this with Government.
- S.31. Postcomm has taken other steps. First, Postcomm has established, in conjunction with the Office of Government Commerce, that Government departments can recover VAT on postal services. This means that new entrants will have a more equal chance of winning business in the 13% of the part of the market that was previously considered to be foreclosed because of the VAT barrier.
- S.32. Second, Postcomm will continue to pursue, through discussions with HM Treasury and Customs and Excise, the possibility of constructing access contracts in such a way as to be able to treat access as a "disbursement", and therefore not liable for VAT. If successful, this would mean that VAT exempt customers would only have to pay VAT on the costs incurred by the consolidator (a relatively small component) and not the full cost of the mailing.

(iii) Potential anti-competitive behaviour

- S.33. The majority of respondents supported Postcomm's proposed measures for dealing with potential anti-competitive behaviour by Royal Mail. The prevailing view was that postal operators and customers must be afforded some protection against Royal Mail's dominant position in postal services. There was particular concern about future developments in downstream access, changes to bulk mail services and any price realignment designed to reflect costs.
- S.34. Postcomm does not have a presumption that Royal Mail will engage in anti-competitive behaviour. However, Postcomm believes that it is important that both new entrants and customers have confidence that processes and arrangements are in place to deal effectively and expeditiously with instances of suspected anti-competitive behaviour by Royal Mail.
- S.35. In addition, Postcomm believes it should err on the side of caution. Experience in the UK and in Europe suggests that anti-competitive behaviour, even unintentional, on the part of the incumbent has been a feature of newly liberalised postal markets.
- S.36. Postcomm has recently reached a decision on one complaint against Royal Mail. The outcome of this investigation was that Royal Mail had appeared to breach Condition 11 of its licence in relation to two promotion schemes in the catalogue market. Postcomm pressed Royal Mail to agree to undertakings strengthening its compliance programme, in order to avoid similar problems occurring again.
- S.37. Postcomm continues to take complaints of anti-competitive behaviour very seriously. Following a complaint by three licensed operators, Postcomm announced in February 2005 that it was undertaking a full investigation of certain aspects of Royal Mail's zonal access contract.
- S.38. Following the consultation, Postcomm has made some minor revisions to its process for dealing with complaints. Postcomm intends to hold a workshop in the near future for new entrants and potential entrants to explain its framework and processes for dealing with anti-competitive complaints.

(iv) Customer awareness and inertia

- S.39. Postcomm believes customers are not generally well informed about the liberalisation of the market and alternative choices. The majority of respondents agreed customer inertia was high. Consistent with its duty of promoting effective competition, Postcomm believes that while competition is in its infancy, it is necessary for Postcomm (and new entrants) to increase customer awareness of the choices available to them.
- S.40. Postcomm will therefore undertake, in conjunction with Postwatch, a programme of visits and events aimed at raising customers' awareness of competition.

Royal Mail's special privileges

- S.41. Royal Mail has historically benefited from a range of special privileges, which were originally considered necessary for the provision of the universal service. These special privileges were all granted at a time when Royal Mail was the national monopoly provider of postal services. Royal Mail's special privileges cover a wide range of operational and business issues.
- S.42. The Government's White Paper "Post Office Reform: A World Class Service for the 21st Century" in July 1999 asked that Postcomm review all Royal Mail's special privileges and advise the relevant Government departments on whether these privileges should be continued or not, or extended to other licensed postal operators.
- S.43. This document outlines Postcomm's final recommendation to the relevant Government departments. Postcomm's approach has been to consider whether or not the privileges act as a distortion to competition, and make a recommendation on that basis, subject to consideration of whether they are absolutely necessary for the provision of the universal service.
- S.44. Some privileges (such as exemption from certain traffic regulations in order to allow Royal Mail to collect from public pillar boxes) are necessary for the provision of a universal service and should be maintained. The possibility of extending these privileges to other postal operators will also be considered if they propose to offer a universal service.

- S.45. A number of the special privileges (such as harbour legislation, or carriage of mail by ship and aircraft) are simply historical legacies that have not been used for at least ten years. In those instances, Postcomm has recommended that the privilege be removed, as they are not essential for the continued provision of the universal service.
- S.46. Postcomm considers that privileges should no longer extend to Parcelforce, since it no longer provides a universal service.

Next steps

- S.47. Postcomm believes it is important that it, and all industry stakeholders, have a thorough understanding of the market and how it might develop. To do this, Postcomm plans to carry out a Competitive Market Review on an annual basis.
- S.48. Postcomm hopes that its September 2004 proposals and this decision document, concluding the 2004 Competitive Market Review, will act as a catalyst to raise stakeholders' awareness of market developments and the opportunities for new entrants, and (perhaps more importantly) encourage stakeholders' continued feedback on how they see the development of the market. This will help Postcomm plan and prepare for the next Competitive Market Review in 2005.
- S.49. If you would like to discuss any aspect of this document, or have any suggestions for the 2005 Competitive Market review, please contact Matthew Ward (on 020 7593 2117 or at matthew.ward@psc.gov.uk) or Pav Dhesi (on 020 7593 2120 or at pav.dhesi@psc.gov.uk).

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1. Introduction

Purpose of this document

1.1. This document sets out Postcomm's decisions on its proposed policy on a number of barriers to entry to the mails market. These barriers were identified in the Competitive Market Review proposals document published in September 2004. It also concludes some issues relating to Royal Mail's special privileges, which were the subject of a consultation in January 2004.

Postcomm's statutory duties

- 1.2. Before the Postal Services Act 2000 (the "Act") was enacted, Royal Mail Group plc, formerly The Post Office, had the exclusive privilege of a monopoly in the provision of postal services within the UK for items weighing less than 350g and costing less than £1 to convey. The changes introduced by the Act established Royal Mail as the successor to the Post Office and Postcomm as the sector regulator with duties in relation to the universal service, consumers and competition. Postcomm's main function is the issuing of licences to operators within the former monopoly area.
- 1.3. Postcomm's universal service duty is to exercise its functions in the manner it considers best calculated to ensure the provision of a "universal postal service". This consists of the delivery and collection at least once every working day of mail (up to 20kg in weight) and the provision of a registered postal service, all at affordable prices that are geographically uniform throughout the UK.
- 1.4. Subject to this, Postcomm is charged with furthering the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators. In doing so, Postcomm must have regard to the interests of those who are disabled or chronically sick, are of pensionable age, are on low incomes, or reside in rural areas.

- 1.5. Subject to both the duties above, Postcomm has a further duty to exercise its functions in a manner which it considers is best calculated to promote efficiency and economy on the part of postal operators.
- 1.6. Finally, in performing all its duties, Postcomm must have regard to the need to ensure that licence holders are able to finance the activities authorised or required by their licences.

Postcomm's vision and regulatory strategy

- 1.7. Postcomm's vision for the postal services market in the discharge of its duties is:

"a range of reliable, efficient and innovative postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market."

- 1.8. Postcomm's strategy recognises that regulation will need to evolve over time. Postcomm believes that its duties will be best discharged by encouraging a dynamic and competitive market that stimulates innovation and customer focus on the part of postal operators. In the short-term, when competition is not sufficiently developed to protect postal users' interests and the provision of the universal service, Postcomm recognises that it will need to regulate the activities of Royal Mail and others.

Postcomm's Forward Work Plan

- 1.9. Postcomm's Forward Work Plan (FWP), which can be found on its website (www.psc.gov.uk), gives details of its duties, functions, objectives and work plan. Postcomm is currently consulting on its 2005/6 FWP.
- 1.10. Postcomm aims to provide customers with choice through effective sustainable competition between postal operators. This means:
 - o a range of credible choices for customers;
 - o a level playing field for competitors with all key barriers to entry addressed;
 - o no abuse of market power by Royal Mail;
 - o real (not just threatened) competition which drives efficiency, cost-reflective pricing, and innovation in products and processes; and

- competition based on credible long-term business propositions.

Process

1.11. Postcomm has based the conclusions set out in this document on the outcome of an extensive consultation exercise. In particular:

- in January 2004, Postcomm issued its “Market Report”¹, setting out how the market was developing, and explaining current trends. This document consulted on the main barriers to entry that may be impeding competition and innovation;
- in the first quarter of 2004 Postcomm conducted an extensive market research survey of business customers (with the consultant, Roland Berger) to listen to their views on competition and how it should be progressed;
- in April 2004, Postcomm discussed market opening with the Operators Advisory Group (OAG). This group of operators (not including Royal Mail at that time) was set up for Postcomm to better understand how operators view the prospects for competition and innovation in the market and what barriers they have to overcome;
- on 5 May 2004, Postcomm issued a consultation letter to stakeholders on its Competitive Market Review. Among the main issues raised were potential options for further market opening. Postcomm complemented this consultation by holding meetings with many stakeholders (including Royal Mail, Postwatch, operators, customers and the unions) to listen to their views;
- in May 2004, Postcomm met the Board of Royal Mail Group to discuss its work programme. A similar event was held with Postwatch’s Council in June 2004;
- on 9 June 2004, Postcomm presented its views on competition to stakeholders at its London Forum event. Postcomm also continues to undertake a series of regional ‘roadshows’ and since January 2004 has been to Belfast, Edinburgh and Builth Wells (Wales);

¹ “The UK Letters Market 2000 – 2003”, January 2004.

- in September 2004, Postcomm published a detailed review of how competition has progressed to date and assessed and consulted on barriers to entry and the prospects for further competition (the Competitive Market Review);
- on 30 September 2004, Postcomm discussed the Competitive Market Review proposals with Postwatch's Personal & Small Business Mail Users Group; and
- Postcomm has carefully considered the responses to its consultation on the Competitive Market Review and the Market Opening proposals (both published on 20 September 2004). The deadline for responses for both of these consultations was 20 December 2004.

Structure of this document

- 1.12. Chapter 2 sets out Postcomm's decision on each of the barriers to entry, following careful consideration of the responses to the September 2004 proposals. Chapter 3 sets out Postcomm's recommendations on certain Royal Mail special privileges, following careful assessment of the responses to the January 2004 consultation document on Special Privileges. Chapter 4 contains Postcomm's risk assessment of the policies pursued in this document.
- 1.13. Annex 1 contains a summary of respondents' views on the Competitive Market Review. Responses to the January 2004 special privileges consultation can be found on Postcomm's website². Annex 2 contains Postcomm's process for dealing with complaints of anti-competitive behaviour.

Feedback

- 1.14. Postcomm hopes that this document will act as a catalyst to raise stakeholders' awareness of market developments and the opportunities for new entrants, and (perhaps more importantly) encourage stakeholders' feedback on how they see the development of the market. Postcomm plans to carry out a Competitive Market Review on an annual basis.

² "Summary of responses to Postcomm's review of Royal Mail's special privileges consultation", January 2004.

1.15. If you would like to discuss any aspect of this document, or have any suggestions for the 2005 Competitive Market review, please contact Matthew Ward (on 020 7593 2117 or at matthew.ward@psc.gov.uk) or Pav Dhesi (on 020 7593 2120 or at pav.dhesi@psc.gov.uk). Postcomm is always happy to meet stakeholders to discuss its policies and listen to stakeholders' views.

2. Barriers to entry frustrating the achievement of effective competition

Introduction

2.1. In the September 2004 Competitive Market Review, Postcomm identified four key barriers to entry. Postcomm consulted on a proposal on how best to approach each barrier. This chapter sets out Postcomm's decision on each and highlights any further work it will undertake.

Royal Mail's downstream economies of scale

September 2004 proposals

- 2.2. In September, Postcomm published its analysis of the extent to which economies of scale exist in eight value chain activities (split into business and consumer mail). Postcomm considered that economies of scale existed most significantly in final delivery to consumers.
- 2.3. Postcomm proposed to continue to promote and monitor Royal Mail's access arrangements. To ensure transparent costing and pricing, Postcomm proposed a greater degree of separation by activity in Royal Mail's regulatory accounts. Postcomm also highlighted that it was considering whether to include access products within the price control from April 2006.

Respondents' views

- 2.4. Responses in general did not dispute Postcomm's analysis that barriers to entry existed in final delivery.

- 2.5. Royal Mail disagreed with some of the detail of Postcomm's analysis of the existence of economies of scale elsewhere in the network. Amongst other things, it considered that collection (especially from individual customers and households) and trunking exhibited greater economies of scale than had been estimated by Postcomm. Conversely, Royal Mail considered that economies of scale were less prevalent in sortation that took place in the downstream part of the pipeline (i.e. inward sortation and walk sequencing).
- 2.6. Many customers and customer groups agreed that access was an important tool in opening up postal services to competition, and many pushed for the speedy development of an access code. Royal Mail considered that regulatory intervention into access was not necessary, as access agreements had been negotiated commercially, and were developing rapidly. The CWU and Amicus/CMA both agreed with this position.
- 2.7. The majority of respondents indicated support for Postcomm's proposal for greater accounting separation, and welcomed the increase in transparency of prices and costs that it could bring. Royal Mail and the unions considered that the proposal was unnecessary. In Royal Mail's opinion the fact that access arrangements had been agreed between commercial parties meant that it was unnecessary (notwithstanding the fact that it has subsequently agreed to increase accounting separation). The unions believed that Royal Mail was already complying with the accounting requirements of the European Postal Services Directive and that was sufficient.

Postcomm's conclusions

- 2.8. Postcomm reaffirms its view that Royal Mail's economies of scale are a significant barrier to entry especially in final delivery. Indeed, after reviewing Royal Mail's response, Postcomm recognises that economies of scale could be a significant competitive deterrent in other value chain activities, such as public collections.
- 2.9. This analysis supports Postcomm's development of access arrangements that effectively shares Royal Mail's unit cost advantage (downstream) with other operators. Postcomm is pleased that Royal Mail has now recognised the benefits of access.

- 2.10. The issue for Postcomm is whether the present arrangements are sufficient to achieve a robust and vibrant market. Postcomm is concerned by some industry sentiment that it needs to move to a greater degree of regulatory intervention in access. The anti-competitive complaint by three licensed operators into Royal Mail's development of an access contract with zonal prices reflects this. Some stakeholders have asked Postcomm to go further and consider whether separation of Royal Mail's activities would provide a more appropriate structure for effective competition.
- 2.11. Postcomm recognises that access arrangements are new and should be given time to develop so that practical experience can be evaluated. Equally, Postcomm recognises that companies base their decisions on expectations and therefore Postcomm may need to take proactive action to influence market sentiment in a way that furthers postal users' interests through the promotion of effective competition.
- 2.12. Postcomm has decided not to make any changes at this stage to Royal Mail's licence condition governing access - if parties fail to reach an agreement, Postcomm stands ready to make a determination on the matter. Postcomm does, however, plan to take the following steps:
- o Price control. Postcomm believes that, in the absence of a suitable code with appropriate regulatory controls, there is a case for bringing access products within the price control from April 2006 when the new arrangements are due to come into effect. Postcomm is considering that and will publish initial proposals for Royal Mail's next price control in May 2005;
 - o Transparency of costs. To improve transparency, Postcomm believes that greater accounting separation is needed. Postcomm has decided to require Royal Mail to split its costs into core value chain activities. Royal Mail has accepted this. Details will be set out in Royal Mail's Regulatory Accounts, which are due to be published later this year. In advance of this, Postcomm will also decide whether this information should be independently audited. Postcomm will formalise the licence arrangements as part of the licence modifications that are required for the price control review; and

- o Further work on ring-fencing. Postcomm has decided to confirm its position set out in its September 2004 proposals to monitor the success of the present access and ring-fencing arrangements. Should Postcomm believe that the access regime is being operated in a way which does not further the interests of postal users nor promote effective competition, it may consider alternatives, such as a greater degree of business unit ring-fencing. To help inform this work, Postcomm's FWP for 2005/6 contains a project that will assess the relative merits of potential options.

Royal Mail's VAT exemption

September 2004 proposals

- 2.13. Postcomm's recommendation to Government, which is responsible for VAT policy, was that Royal Mail's VAT exemption was not required for the universal service and distorted up to 50% of the letters market. This was because some of the largest mailing customers were VAT exempt and therefore could not recover the VAT charged by alternative operators, which would be at the full rate of 17.5%. These customers included banks and other financial institutions.
- 2.14. Postcomm's view was that the Government should pursue a solution that achieved two principal objectives. First, that there should be a level playing field for all postal operators. Second, that the solution should not lead to significant price rises for postal users. As proposed in September 2004, a reduced rate of VAT applied to postal services might be one way to achieve this. The reduced rate of VAT in the UK which is applied to a limited number of products (such as supplies of domestic fuel or power) is currently 5%.
- 2.15. Postcomm proposed to continue to provide advice and analysis to Government to ensure the effects of this barrier to entry were fully understood and, if feasible, addressed as soon as possible.

Respondents' views

- 2.16. There did not appear to be any disagreement over the fact that Royal Mail's VAT exemption was a barrier to entry. Royal Mail did, however, disagree over the extent to which it was a barrier (i.e. the amount of the market that it foreclosed).
- 2.17. First, Royal Mail highlighted the fact that although its VAT exempt status gave it an advantage when selling to VAT exempt customers, it had a disadvantage when competing for VAT registered customers. Royal Mail highlighted that Postcomm's own analysis had indicated that the proposed reduced rate of VAT of 5% (if recovered uniformly across all postal services) would increase the competitiveness of new entrants in relation to customers who are VAT exempt (by around 13%) but would marginally reduce new entrants' competitiveness for those who are VAT rated (by around 3%) so that it would improve the competitiveness of competitors by about 2% overall. Secondly, Royal Mail disputed the amount of the market that VAT foreclosed, considering that Postcomm had overestimated the extent to which VAT acted as a barrier to entry³.
- 2.18. Many customer groups (including Postwatch) agreed with Postcomm's proposed approach of a reduced rate of 5% for postal services. Postwatch believed this solution would not increase the price of stamps for customers. However, TPG NV said that Postcomm should not give up on extending the VAT exemption to all operators.

³ As highlighted by Royal Mail, paragraph 4.48 of Postcomm's September 2004 proposals document stated that Royal Mail's VAT exemption could prevent an extra 4% of the total market volumes being captured by new entrants. The methodology behind this calculation was set out in Annex 2 of the September 2004 proposals document. Paragraph 4.48 was intended to illustrate the effect of VAT on competitors' cost effectiveness compared with that of Royal Mail and was at one extreme of a possible range of multipliers. Consideration of some additional work carried out by Roland Berger (on behalf of Royal Mail) in the light of Royal Mail's comments, suggests that the effect of VAT may be slightly lower – based upon a 10% price differential reducing customer preference to use Royal Mail by 15%. This would lead to a change in the figure quoted in paragraph 4.48 from 1 billion items per year in 2010/11, to an impact of 300 million items. Whilst this figure is an estimate, to put it in context this figure is five times higher than volumes accounted for by new entrants in 2003/4. Competitors to Royal Mail accounted for 57 million items in 2003/4 (0-350g).

2.19. The CWU and Amicus/CMA opposed Postcomm's position and rejected the proposal on the basis that it would lead to an increase in the price of postal services. They believed that removing Royal Mail's VAT exemption would only benefit a small number of large customers and ultimately would put pressure on Royal Mail's ability to provide a universal service.

Postcomm's conclusions

- 2.20. Postcomm has carefully considered the responses to the consultation, and reassessed some of its analysis, as it continues to improve its understanding of the impact of VAT on competitive entry.
- 2.21. In 2004, Postcomm commissioned some analysis from consultants Arthur D. Little (ADL) on the impact of VAT as a barrier to entry. ADL believed that for competitors to win market share from Royal Mail, they would need to offer average price discounts of around 20% to persuade customers to switch. Given operators need to overcome an approximate 13% price disadvantage against Royal Mail for customers that are not VAT recovering before offering a discount⁴, this implies Royal Mail's VAT exemption is a significant barrier to entry.
- 2.22. If anything, the effect is likely to be understated because VAT exempt volumes from customers such as banks and financial institutions (which account for about 43% of volumes from these customers) are very advantageous to building critical mass and scale compared to other market segments, such as single piece items.
- 2.23. Following consultation, Postcomm has decided to reaffirm its recommendation to Government that a solution ought to be found that achieves two principal objectives. First, there should be a level playing field for postal operators. Second, the solution should not lead to significant price rises for postal users.

⁴ The advantage is 13% and not 17.5% because Royal Mail's prices implicitly include its input VAT, which it cannot itself reclaim.

- 2.24. Postcomm continues to believe that a uniform rate of 5% being applied to postal services is consistent with those principles. This is, however, a long term objective. In order to assist HM Treasury, Postcomm will continue to develop further analysis and offer to assist HM Treasury in assessing the impact of VAT on postal services.
- 2.25. The ability to implement Postcomm's proposals for VAT policy is limited by EC legislation. There is currently a proposed EC Directive which, if passed, would enable the proposed changes to the rate of VAT to be charged for postal services. The proposed Directive still has to be approved by the Council of the European Union, following further consultation with the European Parliament. Postcomm will reconsider its position if Council approval is not forthcoming.
- 2.26. Given that Postcomm has limited ability to drive through change in this area and in light of the concern expressed by customers and operators, Postcomm is taking other steps. First, Postcomm has now established, in conjunction with the Office of Government Commerce and HM Treasury, that Government departments can in fact recover VAT on postal services. This removes the distortion caused by VAT in 13% of the part of the market previously considered to be foreclosed.
- 2.27. Second, Postcomm will continue to pursue the possibility of constructing access contracts in such a way that operators can treat access as a disbursement, and therefore not be liable for VAT. This would mean that customers switching to consolidators such as UK Mail would only have to pay VAT on the difference between the retail price and the access price. Postcomm will pursue this through discussions with HM Treasury and Customs and Excise.

Potential anti-competitive behaviour by Royal Mail

September 2004 proposals

- 2.28. The impact of anti-competitive behaviour by Royal Mail could be disproportionately high at the current early stage in the development of competition. Postcomm planned to increase its resources devoted to this issue in order to take a more proactive approach to ensuring anti-competitive behaviour did not occur (or was dealt with quickly).

2.29. Postcomm proposed to take steps to raise awareness within the industry of its processes for addressing complaints, and will organise a workshop for all new entrants.

Respondents' views

2.30. The majority of respondents supported Postcomm's proposed measures to deal with potential anti-competitive behaviour. The prevailing view was that postal operators and customers must be afforded some protection against the risk of abuse (intentional or otherwise) by Royal Mail of its market power in postal services. There was particular concern about future developments in customer downstream access, changes to bulk mail services and any price realignment designed to reflect costs.

2.31. Royal Mail, on the other hand, believed that Postcomm's proposals amounted to an expectation of anti-competitive behaviour, which was misguided given Royal Mail's compliance programme designed to ensure adherence to competition law. The CWU said that Royal Mail should be allowed to respond to competition, and that Postcomm should be careful to ensure that allegations of anti-competitive behaviour are not used by competitors to prevent Royal Mail from doing so.

Postcomm's conclusions

2.32. Postcomm does not have a presumption that Royal Mail will engage in anti-competitive behaviour. However, Postcomm believes that it is important that new entrants should have confidence that processes and arrangements are in place to deal effectively and expeditiously with instances of suspected anti-competitive behaviour by Royal Mail.

- 2.33. In addition, experience in the UK and in Europe suggests that anti-competitive behaviour, even unintentional, has been a feature of newly liberalised postal markets. In Sweden, there was a succession of cases before the Swedish Competition Authority during the first stages of liberalisation after 1993. In Germany, the incumbent operator Deutsche Post was found to have engaged in exclusionary behaviour in 2001 by the European Commission⁵ and this year by the Bundeskartellamt⁶.
- 2.34. In January 2005, Postcomm completed a full investigation into anti-competitive behaviour by Royal Mail⁷. The outcome of this investigation was that Royal Mail had appeared to breach Condition 11 of its licence in relation to two promotion schemes in the catalogue market. Postcomm pressed Royal Mail to agree to undertakings strengthening its compliance programme, in order to avoid similar problems occurring again.
- 2.35. Postcomm continues to take complaints of anti-competitive behaviour very seriously. Following a complaint by the “licensed consolidators”, Postcomm announced in February 2005 that it was undertaking a full investigation of certain aspects of Royal Mail’s zonal access contract⁸.
- 2.36. Conditions 9 to 13 of Royal Mail’s licence are not currently replicated in other operators’ licences, although all postal operators are equally subject to the requirements of UK and EC competition law (enforced principally in the UK by the Office of Fair Trading (OFT)). There are provisions relating to accounting separation in the licences of Deutsche Post Global Mail (UK), TPG Post UK and Mail Plus (owned by La Poste) although these are only reporting requirements.
- 2.37. Postcomm’s proposals were intended to provide a fair and transparent regulatory process for dealing with anti-competitive complaints. They were also intended to publicise this process for the benefit of the whole postal service industry so that, when a complaint is made, all parties involved will know how it will be handled.

⁵ Case COMP/35.141.

⁶ See the press release of 14 February 2005 on the website of the Bundeskartellamt (www.bundeskartellamt.de).

⁷ “Investigation into Royal Mail’s Catalogue and Advertising Promotion Scheme - Decision of the Postal Services Commission”, January 2005.

⁸ “Licensed Operators’ Complaint about Royal Mail’s Zonal Pricing for Access”, January 2005.

- 2.38. In the event that an allegation of anti-competitive behaviour is made against Royal Mail, Postcomm will, as far as possible, ask Royal Mail to respond to it before Postcomm decides whether or not to proceed to a full investigation. That decision will be evidence-based. The process has been designed to prevent any competitor prompting a full investigation – with the administrative burden that can involve – without Postcomm being satisfied that there is a potential case to investigate. In order to further the interests of postal users, Postcomm will also reserve the right to consider “own initiative investigations” in areas where it suspects that competition is not developing.
- 2.39. In view of the above, Postcomm has decided it should establish a regulatory process for handling anti-competitive complaints.
- 2.40. There are two changes to the process proposed in September 2004. First, Postcomm will publish a document setting out the scope of its investigation on its website whenever it starts a full investigation. Second, the process applies to all investigations under Part 4 of Royal Mail’s licence (which covers the promotion of effective competition between postal operators) and not just Condition 11 investigations. The details of the revised process can be found at Annex 2.
- 2.41. Postcomm confirms that it will organise an event for market participants to explain the framework and processes for dealing with anti-competitive behaviour.

Customer awareness and inertia

September 2004 proposals

- 2.42. Postcomm’s market research suggested that customers were not generally well informed about the liberalisation of the market and alternative choices. This may reflect the current early stage of the liberalisation process and a strong brand loyalty to Royal Mail. Postcomm proposed to undertake a programme of visits and events aimed at raising customers’ awareness of the market opening timetable and competition.

Respondents' views

- 2.43. Responses to this issue varied quite widely. The majority of respondents agreed business customers (who send approximately 85% of all addressed mail) were not generally well informed about the liberalisation of the market. However, a number of different views were expressed about whether it would be appropriate or effective for Postcomm to tackle customer inertia through raising customer awareness.
- 2.44. Special Mail Services said that one reason for the customer inertia was Postcomm emphasising its primary aim was a more successful Royal Mail.
- 2.45. A number of other respondents were very supportive of the proposals to increase awareness, including Postwatch who offered to assist Postcomm.
- 2.46. The unions considered that raising awareness, or the promotion of alternative options, was a matter for competitors to Royal Mail not the regulator. The unions argued that the low level of competition merely reflected the fact that Royal Mail's services were better and cheaper due to its economies of scale.
- 2.47. The DMA considered that market awareness was related to the level of competition in the market, which was currently low due to barriers to entry. The DMA therefore believed that, although well intentioned, Postcomm's resources could be better spent on tackling market barriers to entry such as VAT.
- 2.48. Although Royal Mail did not object to Postcomm attempting to raise awareness of market opening, it did not consider it was necessary. Royal Mail interpreted the results of the Roland Berger study differently to Postcomm. Royal Mail considered that the Roland Berger survey results showed that business customers did not have a low awareness of competition in postal services. Royal Mail also considered that business customers had a higher propensity to switch from Royal Mail to an alternative carrier than currently understood by Postcomm.

Postcomm's conclusions

- 2.49. Postcomm has considered Royal Mail's views on the Roland Berger customer survey results. Postcomm, however, continues to believe the results show low business customer awareness, and a low appetite for switching. The results showed that 41% of business customers responding to the survey had yet to be contacted by an alternative provider which, Postcomm would argue, is a significant proportion of customers.
- 2.50. Switching is also currently low, demonstrated by the fact that new entrants to date account for less than 1% of the market. Roland Berger's survey showed only 18% of business customers planned to switch more postal business to new entrants. Furthermore, only 30% of companies said they could envisage using new entrants.
- 2.51. Postcomm considered that the further modelling work carried out by Roland Berger for Royal Mail showed that even if an alternative supplier were to offer the same service using downstream access at a price 10% lower than Royal Mail's (and everything else remained the same) there would only be a further 15% decline in business customer preference to use Royal Mail (i.e. a further 15% of all business customers would state a preference to use an alternative operator). These results show that the Royal Mail brand maintains significant loyalty.
- 2.52. In Postcomm's view, therefore, the balance of the evidence available suggests that business customers are not generally well informed about the liberalisation of the market and alternative choices. The majority of respondents also agreed customer inertia was high.
- 2.53. Consistent with its duty of promoting effective competition, Postcomm believes that while competition is in its infancy, it is necessary to do more to understand and address customer concerns and to increase customer awareness of the choices available to them. However, seeking to ensure the continued provision of the universal service is Postcomm's primary aim, and this has to be made clear.

- 2.54. Postcomm will undertake, in conjunction with Postwatch and others, a programme of visits and events aimed at raising customers' awareness of what Postcomm is doing about market opening and opportunities in the postal market. This includes addressing customers' concerns about ensuring that a multi-operator market works smoothly and what happens where market choice has not yet developed.
- 2.55. Postcomm will also continue to develop its stakeholder contacts to ensure that it is accessible and communicating effectively with a wide range of customers to understand their needs and behaviour in a developing postal market. To measure the success of this work, Postcomm will repeat its customer market survey in 2005.

Other barriers to entry identified by respondents

Quality of service

- 2.56. Special Mail Services raised the issue that forcing Royal Mail to meet quality of service targets that were too high could act as a barrier to entry. It argued that the targets did not currently meet the needs of the market.
- 2.57. Other respondents, however, complained that quality of service (in the form of single daily delivery) was falling, and that this should be rectified.
- 2.58. Postcomm will consider the appropriate level of quality of service targets as part of its work in setting the next price control for Royal Mail. Postcomm plans to issue initial proposals in May of this year.

Reciprocal exclusivity

- 2.59. The MUA urged Postcomm to review the relevant clauses within contracts issued to the UK network of sub-post offices, which prohibited post offices from selling products which competed with postal products and services sold on behalf of Royal Mail.

- 2.60. In its September 2004 Competitive Market Review proposals, Postcomm considered the issue of reciprocal exclusivity. In response, there was strong support from the Postmasternetwork for greater opportunities to deal with alternative postal operators to be afforded to post offices. Postcomm is aware of interest from some licensed operators.
- 2.61. Postcomm proposes to look into this further. First, to assess the legal framework and the scope of Postcomm's powers in this area and, second, to better gauge the interest from operators. Postcomm will also consider the implications of competition on the Post Office network, including for example the way that Royal Mail meets its licence obligation to provide access points for the collection of mail through the network.
- 2.62. This work will be undertaken and initial findings publicised in Postcomm's July report to the Secretary of State.

Ensuring continued provision of the universal service

- 2.63. Royal Mail raised concerns over whether Postcomm could guarantee the continued provision of the universal service following the removal of the barriers to entry identified.
- 2.64. Postcomm's view continues to be that the best long-term universal service safeguard is to ensure that Royal Mail is efficient and customer focussed, through the stimulus of competition. This will help Royal Mail to withstand the longer-term threats from, for example, e-substitution, and the potential risks of reduced growth in mail volumes. Postcomm's previous consultations have highlighted the risks of continued monopoly and its possible effect on Royal Mail's business and its customers.
- 2.65. A trade-off between competition and the universal service is not inevitable:
- o Postcomm discharges its duty to ensure the universal service by placing a licence commitment on Royal Mail, and Postcomm will continue to bear in mind that, when setting the price regulations it places on Royal Mail, Royal Mail will need sufficient revenue to finance the universal service;

- Royal Mails' national daily delivery network has a tremendous competitive advantage and confers significant economies of scale and brand benefits. Indeed, other operators wish to pay Royal Mail to access this network;
- since the establishment of the first access arrangements, when competition started to accelerate, Royal Mail has improved its financial position and its quality of service;
- Royal Mail's renewed plan will further help it withstand competition by making it more efficient and flexible;
- Royal Mail has provided part of the universal service (above 350g) profitably in a competitive market for over 20 years;
- not all Royal Mail's products and services are universal services. In September 2004, Postcomm proposed that only Mailsort 1400 (first and second class) should comprise the generic bulk mail element of Royal Mail's universal service. Royal Mail will also be granted a greater degree of pricing flexibility over time; and
- international experience of liberalised postal markets, such as Sweden and New Zealand, suggests that an affordable universal service can continue to be provided by the incumbent.

2.66. There are other measures available to Government. Under the European Postal Services Directive, member states are permitted to introduce a universal service support fund which can levy contributions from all operators.

3. Royal Mail special privileges (excluding VAT)

Introduction

- 3.1. In its January 2004 consultation on Royal Mail's special privileges⁹, Postcomm identified ten special privileges. Royal Mail's VAT exemption was considered in the September 2004 Competitive Market Review (and Postcomm's decision is dealt with in Chapter 2). Each of the other privileges (and a number of others subsequently identified by Postcomm and respondents) is considered below.
- 3.2. Postcomm does not govern policy on these privileges. This is a matter for the relevant Government department. This chapter represents Postcomm's advice to the relevant Government department from the point of view of Postcomm's duties under the Act.

Background

- 3.3. Royal Mail, as the provider of the UK's universal postal service, has over the years benefited from a range of special privileges which were originally considered necessary for the provision of the universal service. These special privileges were all granted at a time when Royal Mail was the national monopoly provider of postal services.
- 3.4. Royal Mail's special privileges cover a wide range of operational and business issues. The impact of these privileges on the postal services market varies enormously but in some cases it is clear that they do, or have a potential to, distort competition.
- 3.5. The Government's White Paper "Post Office Reform: A World Class Service for the 21st Century" of July 1999 asked Postcomm to review all Royal Mail's special privileges and advise the relevant Government departments on whether these privileges should be continued or not, or extended to other licensed postal operators. Postcomm is aware that any changes to the privileges that the relevant Government department or authority may choose to make may have to await the availability of an appropriate legislative opportunity.

⁹ "A review of Royal Mail's Special Privileges, a consultation document", January 2004.

- 3.6. As outlined in its January 2004 consultation on Royal Mail special privileges, Postcomm has based its recommendation on two key criteria for each of Royal Mail's privileges, which are whether the privilege:
- o is necessary for the provision of a universal postal service; and
 - o has, or could have, a distorting effect on competition amongst postal operators (and, if it does, whether there is any way in which any undesirable distortions can be minimised).
- 3.7. In making these recommendations, Postcomm is aware that the treatment of special privileges may need to change over time. In the early stages of competition, new entrants will not have built up sufficient postal infrastructure to offer a 'complete' range of services. Certain privileges are not likely to be needed by other operators until they have developed their business and infrastructure. Postcomm may therefore need to recommend a further review of particular privileges where action is not currently required but where in the future some change may be justified.
- 3.8. With respect to Parcelforce, Postcomm considers there is no justification for it to continue to enjoy any special privileges given it no longer provides any universal services. Postcomm believes that the benefit of the privileges which apply to Royal Mail should be withdrawn from Parcelforce when a suitable legislative opportunity becomes available.
- 3.9. The section below is structured in the following way for each of the special privileges:
- o the nature of the **Privilege**;
 - o Postcomm's **Provisional view**, as set out in January 2004;
 - o **Respondents' views** on the January 2004 consultation¹⁰; and
 - o **Postcomm's conclusion and recommendation.**

¹⁰ A full summary of non confidential representations to this consultation can be viewed in the competition section at Postcomm's website, www.psc.gov.uk.

Customs clearance procedural exemptions

Privilege

- 3.10. This privilege is set out in regulations made under Section 105 of the Postal Services Act 2000 (the “Act”) and the Postal Packets (Customs and Excise) Regulations 1986. It provides for the use of simplified customs declarations by Royal Mail (as universal service provider) for postal packets (letters, parcels, packets or other articles transmitted by post) being imported into or exported from or in transit through the UK with a value not exceeding £2,000.

Provisional view

- 3.11. Postcomm’s provisional view was that there may be a justification for retaining this privilege provided any distorting effects were minimised and limited. Postcomm encouraged Customs and Excise and all postal operators (including Royal Mail) to work towards a set of agreed procedures which were transparent and fair to all operators.

Respondents’ views

- 3.12. Royal Mail believed the simple customs procedures recognised that national postal operators did not know what items were being sent through their networks for delivery. The counterfactual would be for it to open a significant volume of items to determine their contents. This was in contrast to express operators who had greater control over the complete transaction from acceptance in one country to delivery to another and therefore more control over what third parties placed in their networks.
- 3.13. Royal Mail said international mail was a small proportion of its revenue within the licensed area: customs procedures were therefore not a significant barrier to entry. The CWU and Amicus/CMA also argued this privilege should be retained.
- 3.14. Royal Mail said it was working closely with Customs and Excise to review customs arrangements in the context of the forthcoming changes to the European community customs code.

- 3.15. The majority of other respondents believed this privilege afforded Royal Mail and Parcelforce a considerable advantage and should be removed or extended. The European Express Association (EEA) and an operator argued that given express services were time-critical, Parcelforce had a clear advantage over other operators. The EEA supported a simplified procedure for all. The operator supported removing Parcelforce's exemption given that it no longer provided universal services. The DMA said it supported maintaining the privilege and extending it to all operators.
- 3.16. TPG NV and the MUA argued Royal Mail had as much control over the content of exported mail items as other postal operators.
- 3.17. Postwatch believed, like Royal Mail, that Parcelforce did not have control over what is posted in another country. Postwatch believed this distinguished Parcelforce from other operators. Postwatch also believed Royal Mail not having to complete import/export documentation may actually not be an advantage. The real advantage was in Customs and Excise calculating the duty payable for Royal Mail, while other operators had to do it themselves. For non-USO items, Postwatch argued Royal Mail should be responsible for the calculation.

Postcomm's conclusion and recommendation

- 3.18. Postcomm believes that Royal Mail should retain this privilege in order to handle universal postal service items. This is because Royal Mail does not know the contents of postal items sent to the UK for delivery (which under the UPU treaty¹¹ it is obliged to accept).

¹¹ Universal Postal Union.

- 3.19. However, to avoid competitive distortion due to the time advantage afforded to Royal Mail and Parcelforce, this privilege should be extended to all mail operators. The European Commission is currently proposing that changes are made to Community legislation to establish, as far as practicable, standard customs procedures for all operators who carry small consignments. Postcomm supports this initiative, and recommends Customs and Excise and all postal operators (including Royal Mail) should work towards a set of agreed procedures which are simple, transparent and fair to all operators.
- 3.20. Given Parcelforce no longer carries any universal postal service items, it should be subject to the same customs procedures as other operators.

Exemption from traffic regulations

Privilege

- 3.21. This privilege relates to an exemption from traffic regulations (Traffic Regulation Orders (TROs) made by local authorities under the Road Traffic Regulation Act 1984) for Royal Mail vehicles involved in the provision of a universal postal service. An example of this privilege is the exemption from waiting restrictions for Royal Mail vehicles on yellow lines.
- 3.22. Postcomm understands that local authorities have responsibility to grant Royal Mail vehicles exemptions from waiting or loading restrictions. Postcomm has examined a number of TROs relating to waiting restrictions and found that not all Orders are drafted in the same way. Some Orders grant relief to any universal service provider vehicles engaged in the provision of universal services, loading and unloading postal packets or while postal packets are being collected from post boxes. Other Orders grant similar relief to the "Post Office" vehicles.

Provisional view

- 3.23. There would seem to be a good case for Royal Mail to be able to avoid parking penalties in relation to parking restrictions in order to carry out its universal service role. However, it seems that the broad nature of this privilege could be said to distort competition between Royal Mail and competing postal operators. The impact of this distortion is likely to vary, depending on the precise nature of the restrictions. This is made more complicated by the fact that the nature and extent of Royal Mail's parking privilege varies from one local authority to another and that, even within one local authority area, different local provisions can apply.
- 3.24. It is apparent that any proposed solution to create a level playing field for all postal operators would face considerable practical difficulties given that any widening of Royal Mail's parking privilege could extend to a large number of postal operators (including express and courier firms and parcel companies). Simply extending the privilege to postal operators licensed by Postcomm could create perverse incentives for firms to become licensed operators.
- 3.25. A different approach might be to expect Royal Mail to rely on the general waiting and loading allowances, like other postal operators. Whilst this would remove the distortions created by the traffic regulations, it would only be reasonable to do this if the waiting and loading allowances were sufficient for Royal Mail properly to carry out its universal services obligations.
- 3.26. Another alternative might be to reflect the concerns about the ability of new entrants to provide alternative postal services in an environment where Royal Mail alone enjoys parking privileges and to provide guidance to local authorities as to how distortions to competition might be minimised.

Respondents' views

- 3.27. Royal Mail argued it did not have a special privilege as the exemption from Traffic Regulations applied to all universal service providers. It also said exemptions from waiting and loading restrictions were not automatic and had to be granted by the Highway Authorities. Royal Mail argued exemptions were necessary for the purposes of providing an efficient delivery and collection service and if this were removed, its quality of service would be affected.
- 3.28. Royal Mail also stated that Parcelforce did not claim or enjoy the benefit of such exemptions.
- 3.29. The trade unions argued this privilege should be retained to allow Royal Mail to meet its USO.
- 3.30. The majority of other respondents supported retaining this privilege, with many arguing it should be extended to operators providing similar services. Many respondents argued this exemption gave Royal Mail and Parcelforce a significant advantage. They called for a level playing field, and most supported extending the exemption to operators providing similar services. Four respondents (EEA, an operator, DMA and Postwatch), while supporting certain exemptions to allow Royal Mail to carry out its universal service duties, argued Royal Mail should not enjoy special privileges in providing services that compete directly with express operators. Three of these respondents argued that express services were essential for businesses and therefore should enjoy similar privileges to Royal Mail.
- 3.31. The MUA believed traffic exemptions were necessary for Royal Mail's USO, but only in respect of collections from pillar boxes. The MUA and DMA believed the exemption should be accorded to all licensed postal operators providing USO, but the exemption should either be withdrawn completely, or extended to all postal operators providing similar services. The operator also argued that if express operators were not allowed the same traffic exemptions, then Parcelforce and the non-USO parts of Royal Mail should have to forego these privileges.

3.32. Postwatch believed that except for pillar box collections, for all other types of collections and deliveries, Royal Mail should rely on general waiting and loading exemptions like other operators. Postwatch also suggested that Postcomm should consider providing guidance to local authorities.

Postcomm's conclusion and recommendation

- 3.33. Postcomm believes this privilege is necessary for the provision of a universal service in particular with respect to collections from pillar boxes. From discussions with local authorities and the Department for Transport it is apparent there would be practical difficulties in enforcing traffic exemptions only being applicable to collection from pillar boxes. They also expressed concern that extending parking privileges to all operators would lead to other non postal delivery companies arguing that exemptions should apply to them.
- 3.34. Postcomm does, however, believe this privilege could distort competition and therefore considers that this exemption should be reviewed as competition develops, particularly if operators also begin offering pillar box collections.
- 3.35. Postcomm asks local authorities to minimise the distortion where possible, and give greater consideration to all licensed operators' collection and delivery needs (through for example granting greater flexibility in waiting and loading restrictions generally).
- 3.36. Postcomm will be available to provide ad hoc guidance to local authorities as to how distortions to competition might be minimised.
- 3.37. Given Parcelforce no longer carries any universal postal service items, there is no justification for it to benefit from parking privileges. Postcomm recommends to local authorities that Parcelforce should be subject to the same waiting and loading restrictions as other operators. This distinction is currently reflected in some (but not all) traffic orders.

Carriage of mail-bags by ship and aircraft

Privilege

3.38. This privilege, set out in Section 94 of the Act, allows a universal service provider to serve notice on the owner or operator of a ship or aircraft to carry mail-bags in connection with the universal service, in circumstances where there is no ready access to addresses by road. It also allows disputes on charges for this service to be settled by an independent tribunal.

Provisional view

3.39. This historic privilege is no longer relevant and it should be possible for Royal Mail to enter into commercial negotiations and secure agreement for the transport of mail to outlying areas. Postcomm therefore considers that this privilege should be removed when a suitable legislative opportunity becomes available.

Respondents' views

3.40. The CWU, Amicus/CMA and Royal Mail supported the retention of this privilege to address unforeseen contingencies. Royal Mail argued the privilege was required to allow it to have the necessary tools to fulfil its USO should it come across difficulties in securing reliable, regular transportation to remote/inaccessible areas, given that in some cases this was only possible through a monopoly transport provider and considers that, without this privilege, the maintenance of the universal service could be threatened. In the case that this privilege was used, the fee for the service would either be agreed by the universal service providers and transporters or, in the absence of such agreement, by an independent tribunal.

3.41. The PPA believed the same privilege should apply to all licensed operators operating a universal service where there was no ready access by road.

3.42. Three respondents (MUA, Postwatch, and TPG NV) believed this privilege should be removed on the grounds it was no longer relevant, arguing that Royal Mail should be able to enter into commercial agreements.

Postcomm's conclusion and recommendation

- 3.43. Postcomm believes this historic privilege is no longer relevant. This privilege has not been used by Royal Mail in the last ten years and, in this context, retaining it to cover hypothetical situations is considered too remote a possibility. Royal Mail has demonstrated that it is possible to enter into commercial negotiations and secure agreement for the transport of mail to outlying areas. It is unlikely Royal Mail will require statutory protection against monopoly providers of services. Postcomm therefore recommends that this privilege should be removed.

Harbour legislation

Privilege

- 3.44. These privileges, set out in Sections 97 and 98 of the Act, relate to the protection of postal operators from harbour charges and the control of universal service mail by harbour authorities. Essentially, this privilege seeks to ensure that harbour authorities cannot obstruct the free flow of universal service mail carried by Royal Mail in order to ensure the collection of any harbour duties due.

Provisional view

- 3.45. Postcomm doubted that this privilege was relevant and did not believe that it was needed in order to provide a universal postal service. Therefore it should be removed when a suitable legislative opportunity becomes available.

Respondents' views

- 3.46. Only TPG NV supported removal of this privilege. Royal Mail argued that in order to fulfil its obligations for international mail (both processing of inbound and export) it would be helpful to retain these provisions, so they could be used in circumstances arising which would otherwise result in the mail being detained by harbour authorities without good reason.

- 3.47. The majority of respondents agreed it would be prudent to maintain this privilege in order to prevent harbour authorities from detaining universal service mail. It would also act as a safeguard if the authorities decided to increase harbour fees unreasonably which could be particularly important for providing a universal service where deliveries can only be made via one harbour.
- 3.48. The MUA and PPA believed this privilege should be extended to other licensed postal operators providing similar products and services.

Postcomm's conclusion and recommendation

- 3.49. Postcomm believes this historic privilege is not required to fulfil the USO. Postcomm is also not aware of any significant instance where harbour authorities have attempted to detain mail. Postcomm believe it should be possible for Royal Mail to enter into commercial negotiations and secure agreement for the transport of mail to outlying areas. Postcomm therefore considers that this privilege should be removed.

Immunity from prosecution

Privilege

- 3.50. This privilege, set out in Section 96 of the Act, gives Royal Mail or any other universal service provider engaged in the provision of a universal postal service, the same immunity of prosecution as a Government department for possession of prohibited articles in the post or any failure to comply with appropriate restrictions. Prohibited articles could include the following items: firearms, drugs, offensive material and dangerous chemicals.

Provisional view

3.51. Postcomm considered that there was a case – but not a compelling one – that this privilege was required for universal service reasons. Whilst it could be argued that the privilege had a distorting effect on competition it appeared that new entrants could overcome those distorting effects by having in place appropriate procedures. Postcomm’s provisional view was that this privilege should be retained but that it should be subject to a more thorough review if, in practice, the distorting effects of it are greater than currently seems to be the case. In this context, Postcomm noted that much of the mail handled by Royal Mail is collected directly from contract customers rather than posted anonymously in pillar boxes.

Respondents’ views

- 3.52. Royal Mail argued this privilege was essential to the provision of a universal service. Principally it had no means of preventing prohibited items entering the postal system if senders posted items into pillar boxes. It argued it had limited powers to open packets to ascertain their contents under schedule 83 of the Act. The Trade Unions also supported the retention of this privilege.
- 3.53. Postwatch and the PPA believed there was no case for retaining this privilege except for items of mail posted in pillar boxes (and this should be applied to all operators). For other postings, Postwatch argued Royal Mail had as much control over what was being posted as the other operators. Postwatch argued that other operators had to maintain systems to check they did not carry prohibited items, which imposed additional costs and therefore potentially distorted competition.
- 3.54. Three respondents (MUA, TPG NV and the Civil Aviation Authority) supported removing this exemption. The Civil Aviation Authority said it would like to see any part of Royal Mail (including Parcelforce) which acted as a shipper for the purposes of the Air Navigation (Dangerous Goods) regulations 2002 (which regulate the carriage of dangerous goods by air) subject to those regulations and not immune from prosecution.

Postcomm's conclusion and recommendation

- 3.55. Postcomm believes that Royal Mail should retain this privilege. This is because Royal Mail does not know the contents of mail inserted anonymously into its pillar boxes (which is then streamed with mail collected via other channels). Royal Mail in fact recently asked Postcomm to prohibit the carriage of firearms in its mail service claiming that despite their legal status, the sending of them by the standard post causes disruption to their services (Postcomm is currently consulting on this issue).
- 3.56. Postcomm, however, believes that as competition develops, this privilege could be reviewed and extended to all operators who provide a public collection service.

Compulsory purchase powers

Privilege

- 3.57. This privilege, set out in Section 95 and Schedule 5 of the Act, gives Royal Mail and any other universal service provider the power to purchase compulsorily any lands it requires in connection with the provision of a universal service. Land can be subject to compulsory purchase only if the Secretary of State so authorises Royal Mail.

Provisional view

- 3.58. Postcomm's initial view was that there was not a compelling case for Royal Mail to retain privileges relating to the use of compulsory purchase powers. Royal Mail should be able to employ normal commercial means to obtain land or gain access to it. Postcomm's provisional view was that this privilege should therefore be removed when a suitable legislative vehicle becomes available.

Respondents' views

- 3.59. Royal Mail believed this was an important fall back power, which was likely to have more not less importance in the future with the disappearance of suitable town centre sites for Royal Mail delivery offices. It also stated that this privilege is strictly limited to the provision of the universal service and was available to all other universal service providers.
- 3.60. Three other respondents supported removal or partial removal of this privilege. TPG NV and the MUA believed this privilege should be removed. Postwatch believed Royal Mail should be able to employ normal commercial means to obtain land. However, Postwatch believed the privilege to acquire easements (i.e. access rights) or rights over land could be important for the purpose of securing access to operational premises. Postwatch therefore believed there was a case for exposing this element of the privilege to further analysis.

Postcomm's conclusion and recommendation

- 3.61. Postcomm does not believe this privilege is required for the USO. In the last ten years, only three applications have been made to the DTI, and none have actually been followed through. Postcomm believes Royal Mail should be able to enter into commercial negotiations and secure agreement for land or access to it. Postcomm therefore considers that this privilege should be removed.

Provision relating to public pillar boxes

Privilege

- 3.62. This privilege, as set out in Section 95 and Schedule 6 of the Act, gives Royal Mail and other universal service providers certain powers in relation to placing pillar boxes and pouch boxes in the street. These statutory provisions enable Royal Mail to install pillar boxes and pouch boxes in streets, subject to obtaining the necessary local authority consents.

Provisional view

3.63. Postcomm's provisional view was that this privilege was necessary for the provision of a universal service and that it did not seem to have any distorting effects on competition. Accordingly, Postcomm considered that the privilege should be retained. Postcomm did, however, note that, if in the future, competitors wished to offer services involving public collection of mail via pillar boxes (but not on a universal service basis) there would seem to be a case for extending this privilege to such operators.

Respondents' views

- 3.64. The majority supported the retention of this privilege, as well as extending it to other postal operators. The MUA, PPA and Postwatch believed Royal Mail should retain this privilege and this privilege should be extended when other postal operators were in a position to offer public collection services.
- 3.65. Royal Mail argued this privilege was necessary for the provision of the universal service. Although the provision of postal pouch boxes was not a universal service requirement, Royal Mail argued they were necessary to facilitate efficient delivery services. Royal Mail, however, questioned whether this exemption should be extended to non-universal service providers, arguing this could lead to a large number of visually intrusive boxes and possible obstruction of the highway.
- 3.66. TPG NV argued pillar boxes should be subject to local planning rules only. This should be open to anyone under the same conditions and restrictions.

Postcomm's conclusion and recommendation

3.67. Postcomm believes that this privilege is necessary for the provision of a universal service and it currently does not distort competition. This privilege should therefore be maintained. However, if in the future, competitors wish to offer services involving public collection of mail via pillar boxes (not necessarily on a universal service basis), Postcomm recommends reviewing this privilege.

Classification of Royal Mail as a private carrier

Privilege

- 3.68. Section 99 of the Act classifies a universal service provider as a private carrier of mail, and not a common carrier.
- 3.69. Common carriers may only refuse to carry goods for certain reasons such as a lack of available space in vehicles, or the destination of the packets not being one the common carriers usually travel to.

Provisional view

- 3.70. Postcomm's provisional view was that this statutory provision was not a privilege but made it clear that a universal service provider was not required to take on the obligations of a "common carrier". It has no impact on competitors to Royal Mail. Postcomm therefore considered that this provision should be retained.

Respondents' views

- 3.71. The Trade Unions, MUA, and the PPA supported the retention of this privilege. The MUA and PPA believed this should be applied to all licensed operators when providing a universal service.
- 3.72. TPG NV believed this privilege was unnecessary, saying all other operators included terms that were not common carriers, and that Royal Mail could easily do the same.

Postcomm's conclusion and recommendation

3.73. Postcomm believes this statutory provision is not a privilege as such but is there to make it clear that a universal service provider is not required to take on the obligations of a "common carrier". Without this, a universal service provider might be regarded as a common carrier. This would make it liable to carry a wide range of goods and not just postal items which would mean it could be required to carry items other than mail. It has no impact on other operators. Postcomm therefore believes this provision should be retained.

The powers to make schemes (Sections 89 and 92 of the Act)

Privilege

3.74. Royal Mail, as a universal service provider, is able to make special schemes which govern the terms under which it provides its universal services. These powers are set out in sections 89-92 of the Act and include a statutory exclusion of liability for negligence. Section 93 of the Act enables the Secretary of State to modify those statutory provisions, by order, following consultation with Postcomm and Postwatch.

Provisional view

3.75. Postwatch and Postcomm had already raised with the DTI the case for reviewing these provisions. In the light of those separate developments, a recommendation was not made in the January 2004 consultation.

Respondents' views

3.76. Postwatch's view was that the power to make schemes was important to universal service providers in providing "terms and conditions" for customers without needing to enter into individual contracts with everyone. The PPA argued this power should be extended to all operators where operating as a universal service provider.

3.77. TPG NV argued that when competition was opened beyond business mail, it would seem appropriate that this issue be reviewed.

Postcomm's conclusion and recommendation

- 3.78. The power for universal service providers to make schemes for the conveyance of letters with limited liability, under sections 89-92 of the Act, gives rise to a number of concerns in the context of introducing competition to the postal market. The power to make schemes provides a framework for a postal operator to establish a clear, non-contractual, legal relationship with the addressee of mail as well as with the sender. Although that advantage perhaps is of less importance than it used to be, since the introduction of the Contracts (Rights of Third Parties) Act 1999, Postcomm sees no clear rationale for restricting the ability to make schemes to universal service providers and therefore, effectively, to Royal Mail.
- 3.79. In the past there has been a considerable lack of transparency as to the terms of Royal Mail's schemes. In response to pressure from Postcomm, Royal Mail has addressed this problem and has made available on its website consolidated and updated versions of the five schemes it has made. This is to be welcomed, but Postwatch has made the point to Postcomm very strongly that the schemes are out of line with the standards of consumer protection that apply in other fields of commerce.
- 3.80. Both organisations have been in discussion with the Department of Trade and Industry with a view to modernising the power to make schemes so as to improve the degree of consumer protection, address the potential for distortion arising from the power to make schemes and ensure better compliance with European postal legislation. This work with the Department of Trade and Industry is continuing and, consequently, Postcomm does not make any definite recommendation in this document. Postcomm expects that this issue will be the subject of a separate consultation.

Further potential privileges raised by stakeholders

3.81. The MUA and Postwatch believed there were a number of other privileges which Postcomm should assess. These were Royal Mail's ownership of the Postcode Address File, exclusive rights to carry the Queen's image on stamps, the licensing of franking machines, and Royal Mail's "reciprocal exclusivity" agreement with Post Offices. Each of these is considered below.

Licensing of franking machines

3.82. The issue of Royal Mail exclusively licensing franking machines for its mail was raised by the MUA and Postwatch in their representations on the January 2004 consultation.

3.83. The franking machine market is currently being investigated by the OFT. Postcomm will assist the OFT wherever possible on this issue.

Stamps with HM the Queen's image

3.84. Royal Mail's sole ability to issue stamps with the Queen's image was raised by the MUA and Postwatch in their representations to the January 2004 consultation. Postcomm understands that the issue is one of branding. For example, some direct marketers consider that the use of a standard stamp improves response rate.

3.85. Postcomm does not believe this is currently a distortion of competition, given new operators do not currently issue their own stamps.

Health and safety legislation

3.86. Health and Safety issues were raised by Postwatch in their representations to the January 2004 consultation.

3.87. Certain exceptions to Royal Mail's universal service obligation exist to enable it to comply with health and safety legislation (for example if customers fail to provide suitable access for Royal Mail staff, causing health and safety risk).

- 3.88. At present Royal Mail is the only operator with a universal service obligation. If another operator had a similar obligation and sought a similar exception, then it is highly likely that it would be so granted by Postcomm.

Working Time Directive

- 3.89. The issue of the Working Time Directive was raised by Postwatch in its representations to the January 2004 consultation. This point refers to working time limits under the 1998 “Working Time Regulations” (which came into force in October 1998) which implemented the European “Working Time Directive 93/104”.
- 3.90. Under these regulations, workers can agree to work longer than the 48-hour limit. An agreement must be in writing and signed by the worker. This is generally referred to as an “opt-out”. Postcomm does not consider this as a privilege exclusive to Royal Mail.

Postal address file (PAF)

- 3.91. The MUA questioned whether it was appropriate for Royal Mail to retain sole rights to ownership of PAF, given the competitive advantages it may offer over other market entrants.
- 3.92. Postcomm is currently carrying out a review of Royal Mail’s management of the PAF. A consultation document was issued in June 2004, which can be viewed on Postcomm’s website at www.psc.gov.uk. Postcomm expects to publish its proposals for PAF by the summer, with a final decision by the end of 2005/6.

Vetting employees for criminal records

- 3.93. Since July 2004, Royal Mail has been granted access to conduct criminal record checks for vetting new employees. This privilege was granted by the Home Office. Other licensed operators have argued they also should be able to allowed to conduct such checks and were concerned about the advantage this would afford Royal Mail if this privilege remained only available to Royal Mail.

3.94. The Home Office has confirmed to Postcomm that licensed operators can also make applications for access to conduct criminal records checks. Postcomm supports extending access for all licensed operators, to improve the mail integrity of the postal market.

4. Risk assessment

Introduction

- 4.1. Postcomm believes that in making any major regulatory decision, it should assess the risks inherent in its actions, including the risk of not taking any action. This is consistent with regulatory best practice.
- 4.2. Postcomm has identified a number of risks associated with the decisions taken in this document. These are:
 - o too much competition undermining the universal service, following the removal of the barriers to entry identified in this document;
 - o too little competition to change Royal Mail's behaviour, despite the removal of the barriers to entry identified in this document;
 - o Condition 11 of Royal Mail's licence and the Competition Act 1998 (CA98) will not be sufficient to prevent Royal Mail from acting anti-competitively;
 - o Royal Mail's service standards become a barrier to entry;
 - o Royal Mail's prices become a barrier to entry; and
 - o risk of delays to common operational procedures.

Too much competition undermining the universal service

- 4.3. Postcomm continues to believe that the best long term safeguard for the universal service is an efficient, innovative and customer focussed Royal Mail and that the best environment to encourage this is a competitive market rather than a monopoly.

- 4.4. Postcomm recognises that competition, under certain circumstances, could cause problems for Royal Mail's ability to provide services that it might seek to avoid if it were free from all constraints. Postcomm notes Royal Mail's concern that some aspects of its tariff structure are not well aligned with its costs (e.g. the geographically uniform tariff) which may pose risks based on unsustainable arbitrage opportunities (called "cream skimming" by Royal Mail). There are a number of reasons why Postcomm considers this risk not to jeopardise the provision of the universal service:
- Royal Mail is seeking a greater degree of pricing flexibility. This includes clarifying those products that are included and excluded from the uniform pricing constraint as well as other pricing initiatives, and Postcomm is putting in place further resources to deal with this issue as efficiently and effectively as possible;
 - Royal Mail has now negotiated commercial agreements with four other operators to have access to its local delivery network. This reinforces Royal Mail's competitive position in delivery;
 - Royal Mail's regulatory accounts (based on the company's allocation of costs) show that, on average, it makes a loss on the part of the market that is not yet opened to competition, which may dissuade some operators from entering the market; and
 - Postcomm's ongoing analysis of the impact of competition on Royal Mail's business further supports this view, as does international experience from those countries that have fully liberalised their markets, such as Sweden and New Zealand.
- 4.5. Clearly, there is always some degree of uncertainty over how the market will develop, and Postcomm has identified a number of potential risks in this chapter. If any of these risks do materialise, then Postcomm believes it has adequate mitigation measures available. Postcomm will continue to monitor the market closely in order to ensure the universal service is maintained and strengthened.

Too little competition to change Royal Mail's behaviour

- 4.6. Given the background of Royal Mail's current poor (but improving) quality of service performance against its agreed targets, Postcomm is concerned that this is currently the most pressing risk facing the regulatory regime.
- 4.7. Postcomm has so far taken a decision to bring forward full market opening to 1 January 2006¹² and hopes that this will strengthen the incentives on Royal Mail to improve its performance and customer focus. Postcomm is also currently reviewing Royal Mail's price control and its quality of service targets. An important consideration will be the incentives that Royal Mail has to improve its efficiency and its quality of service.
- 4.8. Royal Mail's quality of service, although poor, is slowly improving. Postcomm is committed to periodic Competitive Market Reviews in order to assess whether the situation has changed and to inform regulatory action to improve the prospects for competition to further postal users' interests. This will also address the risk that there is uncertainty about how the market will develop in the medium to longer term.

Condition 11 of Royal Mail's licence and the Competition Act 1998 will not be sufficient to prevent Royal Mail from acting anti-competitively

- 4.9. Postcomm recognises that Royal Mail will "fight for every letter" and much of this activity will be within the general cut and thrust of business. However, given Royal Mail's market position, Postcomm is keen to ensure Royal Mail does not abuse its market power and foreclose the market before competition has had a chance to gain a foothold.
- 4.10. Postcomm will use its powers under Royal Mail's licence if it believes that Royal Mail has acted in an anti-competitive way. It will also work closely with the Office of Fair Trading (OFT) to ensure that Royal Mail does not breach the prohibitions of general competition law, in particular, the Competition Act 1998 and Articles 81 and 82 of the EC treaty.

¹² "Giving Customers Choice: a fully open postal services market", 18 February 2005.

4.11. However, Postcomm is aware that ex post action, such as the use of Condition 11, may only take effect after a competitor has been forced out of the market. In the future, Postcomm expects to review the effectiveness of Condition 11 and consider whether ex ante regulation (e.g. through the price control) would be more effective.

Royal Mail's service standards become a barrier to entry

4.12. Despite a recent upturn in performance, Royal Mail's quality of service has been a cause for concern for postal users. A key challenge for Royal Mail, Postcomm and Postwatch, is to develop a framework that improves quality of service for all users. However, it is important that quality of service targets (and the associated framework) are set at the right level. It is important that they meet customers needs, do not require an excessively high quality of service (i.e. more than is required by the customer, and at a higher price than is necessary), and do not act as a barrier to entry.

4.13. In June 2004, Postwatch, Royal Mail and Postcomm jointly commissioned research by MORI to better understand the needs and expectations of Royal Mail's customers in relation to quality of service standards. The objective of the research was to:

- o establish customer requirements of a universal postal service in terms of speed of delivery, reliability and security; and
- o assess customer expectations of quality over the period of the next price control.

4.14. This research is set out in detail in a consultation document published by Postwatch (available at www.postwatch.co.uk). It sought the views of the industry, major stakeholders and customer groups on the appropriate quality of service measures. This will allow Postwatch and Royal Mail to discuss how the quality of service measures should be developed to complement Postcomm's review of Royal Mail's price and service regulation.

Royal Mail's prices become a barrier to entry

- 4.15. Postcomm notes this concern of potential entrants. Postcomm would be very concerned if it believed that Royal Mail was pricing in a way that was anti-competitive and therefore a breach of either its licence conditions, general competition law or both. For many key services, Postcomm has powers under Royal Mail's licence to ensure it does not, in the absence of competition and an overriding universal service need, price those services in a way that is predatory, unduly discriminatory or unduly preferential.
- 4.16. Postcomm, however, does not believe it is in postal users' interests simply to raise Royal Mail's prices to enable operators to take the business away. This is not in customers' interests, whose needs are ultimately what Postcomm is charged with serving.
- 4.17. That said, in making decisions on the price control about setting prices at a level that reflects forward looking efficient costs, Postcomm will take into account the potential impact on competition. Postcomm's initial price control proposals will be published in May 2005.

Risk of delays to common operational procedures

- 4.18. Arrangements are needed among operators to underpin a multi-operator environment (e.g. redirection of letters that have inadvertently been posted into another operator's network). Although doing all it can to introduce effective competition (whilst seeking to ensure the continued provision of the universal service), Postcomm is concerned by the risk of there not being such arrangements in place.

4.19. Postcomm is currently consulting on proposals in relation to common operational procedures and mail integrity¹³. In addition, Postcomm considers that it has contingency plans for any issue that fails to be resolved. For example, if arrangements for mis-directed mail cannot be agreed by 1 January 2006, Postcomm proposes to use Freepost as a fall back. Currently some operators are using Freepost as a means of ensuring that misdirected mail is returned to the sender via the correct operator. This is not a long term solution, but Postcomm considers that it will be sufficient as an interim solution if absolutely necessary.

¹³ "A postal code of practice for common operational procedures", 18 March 2005, and "Protecting the integrity of mail – a code of practice", 18 March 2005.

Annex 1 – Summary of respondents’ views on the Competitive Market Review

Introduction

A1.1. In September 2004, Postcomm published a competitive market review proposals document for consultation. Some 15 responses were received to this consultation and their views are summarised in this annex.

Proposal to continue to promote and monitor access arrangements

A1.2. The majority of respondents supported the proposal. The major user groups (PPA, DMA, and MUA) agreed downstream access is a key method of developing competition and offering customers choice. All three said it was important for Postcomm to use all its regulatory measures to ensure a generic access code is developed quickly and effectively. The DMA said that although access is viable for competing operators, it does not seem viable for consolidators (with consolidation licences) and this area needed to be addressed to ensure it is attractive to consolidators, given that they are important in attracting SMEs and new users to the postal market. Postwatch also supported this proposal, believing it will be some time before alternative end-to-end competition to Royal Mail emerges. Special Mail Services also welcomed measures to monitor access arrangements. However, it believed Postcomm should place more emphasis on the development of end-to-end competition.

- A1.3. Postmasternetwork said it was essential that access to post offices is also created. They supported the removal of the competition restrictions in sub-postmaster contracts. Postmasternetwork said they would then be able to work on behalf of sub-postmasters to develop commercial arrangements with new entrants. This would create a new income stream for sub-postmasters. Postmasternetwork believed a number of areas should be explored: (a) the use of Post Offices for the collection of mail order returns which can then be collected by the mail order companies; (b) the aggregation facility for mail from SMEs, and (c) collection points for third party mail to enter the Royal Mail system given most sub post offices are already on Royal Mail collection runs.
- A1.4. The trade unions however did not support the proposal. They believed the proposal was unnecessary and not consistent with Postcomm's aim of promoting a liberalised market. Amicus/CMA and SERTUC said this policy demonstrated Postcomm's lack of commitment to protecting the universal service. The CWU said it remained to be persuaded about the desirability of third party access, and it did not see the necessity for Postcomm to increase its involvement at the present time given Royal Mail has been able to reach apparently satisfactory commercial arrangements. The CWU and SERTUC argued a period of stability was needed during which time no further liberalisation activities are undertaken. This would allow time to measure the impact of third party access.
- A1.5. TPG NV also did not support the proposal, arguing that trying to introduce competition through access had deterred would-be investors from setting up rival delivery networks, which required more significant and riskier investment than providing upstream services.

Proposal for a greater degree of separation by pipeline activity in Royal Mail's regulatory accounts

- A1.6. The majority of respondents supported a greater degree of separation by pipeline activity in Royal Mail's regulatory accounts, and a number believed Postcomm should consider vertical separation. The PPA said it cautiously welcomed the proposal and argued the accounts should include costs, broken down by pipeline activity. It argued that the achievement of a transparent cost and pricing structure is considerably overdue. It believed there was currently insufficient transparency to be sure there is no direct market abuse, or unfair competitive advantage for Royal Mail. With respect to vertical separation the PPA argued Postcomm should set a target for achieving the necessary transparent cost and pricing structure. If this is not achieved, then there is a strong case that Royal Mail should be separated into upstream and downstream activities. The DMA said Postcomm should consider full structural separation of Royal Mail between delivery, sortation and collection. Such separation would allow sortation to compete with consolidators/integrators and Royal Mail Delivery to develop as a major service offering.
- A1.7. Postwatch believed Postcomm could require management separation (not ownership separation) of the pipeline through the licence. It believed access to the pipeline is fundamental to the development of competition, particularly the last mile, and as a consequence its costs must be accurately understood. It believed a further step towards achieving fair and equal access is to require the marketing arm of Royal Mail to have access to the pipeline on the same terms and conditions as its competitors. The objective of pipeline management would be to maximise the amount of mail they are delivering to boost earnings regardless of the source of mail. As a separate accounting entity the actual costs of the pipeline will be visible to the regulator. WWAV Rapp Collins, although believing structural separation would guard against upstream and downstream discrimination, recognised the potential disadvantages of such a scheme. It believed strengthening of the sector's regulatory and investigatory structure to make it more rigorous and proactive, was a simpler solution.

- A1.8. Royal Mail argued downstream access has been achieved through commercially negotiated contracts, with minimal regulatory involvement. It argued the success of these contracts supported its view that proposals for a greater degree of accounting separation for access operations and controlling access prices was unnecessary and likely to be counter productive.
- A1.9. The trade unions believed this proposal was unnecessary. The CWU believed that Royal Mail was already meeting the accounting requirements set out in European Union legislation. Both the CWU and Amicus/CMA said they would view accounting separation as the first step towards a more profound separation of Royal Mail's business activities, an initiative they would both strongly oppose.

Should access products be included within the price control from April 2006?

- A1.10. Royal Mail, the trade unions and the DMA opposed this proposal. Royal Mail and the CWU argued downstream access has been achieved through freely negotiated contracts, with minimal regulatory involvement. They argued the success of these contracts supported their view that proposals for controlling access prices were unnecessary and likely to be counter productive. The CWU also believed an access code was unnecessary for this reason. Amicus/CMA argued that, subject to universal service requirements, Postcomm should regulate those parts of the market where customers do not currently or are not expected in the foreseeable future, to benefit from competition. It argued it is too early to assess the impact of competition as access arrangements have only been in place for a short time. In its view, access products remain the only significant segment of the market that is currently unregulated, and the only sector where competition had made an impact. It argued that to include this within the price control would contradict the regulatory light touch approach advocated by Postcomm. Amicus/CMA also did not see the need for an access code. The DMA also said bringing access products within the price control would be regulatory interference in a competitive environment.

A1.11. A number of respondents however argued access pricing needed to be subject to regulatory oversight. Special Mail Services, the MUA and Intellect said in the absence of a universally agreed access code, the price of access products should be controlled. Intellect said this should be linked to a market share limitation to give Royal Mail some protection in the future from new competitors selling under the access price. Postwatch said if access prices are de-averaged it is essential that this process is subject to regulatory oversight. Consequently, it believed it was appropriate for access pricing to be controlled. The PPA commented that there was a clear need for continued price controls for products such as Presstream for which there is no viable alternative national supplier.

A1.12. TPG NV believed if zonal pricing and other access proposals are left uncontrolled, there would be no competition. Royal Mail's ability to offer access prices without any prior review by Postcomm was in its opinion being used to destabilise the market. The effect of this was to dissuade customers from choosing to use the services of a rival operator. It argued Postcomm needs to have *ex ante* control of access and new services pricing to prevent this.

Comments on the recommendation that Royal Mail's VAT exemption should be removed and replaced with a reduced VAT rate on postal services

A1.13. The majority of respondents (DMA, MUA, Postwatch, PPA, Special Mail Services, and TPG NV) agreed Royal Mail's VAT exemption was a significant barrier to entry. The major user groups expressed support for a reduced VAT rate. The PPA said Postcomm's analysis showed how a reduced rate of VAT could be applied without resulting in a significant increase in prices and should be pursued accordingly. The MUA similarly supported Postcomm's continuing advice to Government that a solution needed to be found for Royal Mail's VAT exempt status, and that a reduced rate might be one way to achieve a level playing field. The DMA said the VAT issue needed to be understood from a European perspective. It argued it is essential that the UK forced the pace, and such a solution should encompass: (a) removal of Royal Mail's VAT exemption (b) introduction of a low rate of VAT, probably 5% on items up to, say, 2kg, with the standard rate beyond this (c) a rebate system for charities and financial services, to allow for their inability to reclaim VAT (d) interim provision of VAT only being charged on trunking for new operators (e) no VAT on stamps.

A1.14. TPG NV said Postcomm should not presume a VAT exemption cannot be extended to all postal operators. It said postal operators were going to make a request to the UK Government to extend the VAT exemption, arguing there was considerable legal support for this. It said they would welcome Postcomm's support for this possible outcome.

A1.15. Three respondents however opposed removing Royal Mail's VAT exemption. Royal Mail said though it agreed with much of Postcomm's analysis of the impact of VAT, it continued to oppose the proposal, arguing it would lead to a 15% price rise for the majority of customers. Royal Mail argued Postcomm's analysis concentrated on large customers, where entry is most likely, and showed that for these customers the impact on price competitiveness is quite small because the majority can reclaim input tax. Royal Mail also argued that Postcomm was trivialising the significance of price rises for households that a reduced rate of VAT would imply.

A1.16. The trade unions also opposed the proposal. The CWU believed any overall increase in the price of postage should be reserved for those occasions when an increase is necessary to meet the rising costs of the universal service provider. It believed removing Royal Mail's VAT exemption would only benefit a small number of large businesses, with the majority of customers including social, small business, charities, educational establishments, and financial institutions likely to have to pay higher postal charges. It also argued the removal of Royal Mail's VAT exemption is likely to increase the pressure on Royal Mail's ability to meet its universal service obligation. It believed Postcomm should reconsider its proposal, and withdraw this recommendation.

A1.17. Amicus/CMA argued the current distortion provided Royal Mail's competitors with a slight advantage when targeting VAT recovering customers. The removal of the distortion could therefore be expected to increase competitive entry in one segment and reduce it in another. It argued removal of the VAT exemption would not benefit small, private or rural customers but will open the business to customer segment to more large operators. It argued social customers, including elderly, charities and small businesses would not be able to bear the increased costs and this could lead to a switch away from postal services.

Proposal to be more proactive with respect to anti competitive behaviour and take steps to raise awareness within the industry of the processes for addressing complaints.

A1.18. A number of respondents (DMA, MUA, Postwatch, Special Mail Services and WWAV Rapp Collins) supported the proposal to be more proactive with respect to anti competitive behaviour. WWAV Rapp Collins said Postcomm should not just focus on anti competitive behaviour that damages rival postal operators. It said Royal Mail is increasingly expanding into related markets and it could use its monopoly position effectively to subsidise these ventures. For example, Royal Mail could try and secure the mail items that could be processed by competitors for itself by tying upstream services to its downstream services. It argued that this must be properly scrutinised.

A1.19. The MUA cautioned Postcomm on the thin line between the pricing strategies proposed by Royal Mail to rectify price alignment with costs, and those that arguably verge on anti-competitive behaviour. It was concerned that Royal Mail in its endeavour to fight for every letter might walk too closely to the line. The DMA believed that Postcomm should act within its existing powers under the licence and the Act and examine the following areas: (a) the application of Royal Mail's downstream access guide, (b) inconsistencies in the application of mail presentation criteria, (c) the switch within Mailsort from an aggregation of posting over 20 days to a requirement that the date of postage is calculated on each daily posting, and (d) ensuring the quick and effective introduction of an access code.

A1.20. Royal Mail expressed disappointment at Postcomm's expectation of anti-competitive behaviour. It argued it has demonstrated its determination to avoid predatory or discriminatory behaviour with a comprehensive compliance programme designed to ensure adherence to competition law. It argued the proposed procedures need only be implemented when and if firm evidence of anti-competitive behaviour emerges.

A1.21. The trade unions said that in a liberalised market, Royal Mail must be permitted to compete on an even and fair basis with other operators. The CWU said there was a danger of permitting other operators to utilise anti-competitive behaviour concerns as a means of unfairly furthering their own business interests at the expense of Royal Mail. The trade unions believed it was vital for Royal Mail to be able to compete on a level playing field and not to be artificially prevented from justified action in protection of its business. Amicus/CMA asked how Postcomm intended to make the distinction between the thin line between practices that fall within the general cut and thrust of business and those that could be deemed anti-competitive. It also believed it was unnecessary to devote more resources to this area, given condition 9-13 of Royal Mail's licence already prevented Royal Mail from carrying out anti-competitive activities.

Customer inertia: proposal to raise customer awareness of the market opening timetable and competition.

A1.22. A number of respondents commented on this proposal. Royal Mail said that, although it had no objection to Postcomm's proposed market awareness programme, it was not convinced it was necessary. Its interpretation of the Roland Berger customer survey (reinforced by some additional work by Roland Berger) was that customer awareness and the potential for switching is high.

A1.23. The trade unions opposed this proposal. They believed the promotion of alternative options is a matter for the other postal operators and should not necessitate a role for the regulator. The CWU said Postcomm should act objectively, and should not seek to further the interests of Royal Mail's competitors at the expense of the universal service provider. Amicus/CMA argued that small scale entry reflected the fact that Royal Mail services are better and cheaper due to its economies of scale. It is yet to be convinced that competition will not simply mean reduced postal prices for some customers at the expense of smaller, non-commercial customers.

A1.24. Special Mail Services argued Postcomm is partly to blame for customer inertia by conveying the message that its primary aim is a more successful Royal Mail. Special Mail Services believed this has resulted in customers thinking that they are better off waiting for Royal Mail to improve. Special Mail Services also argued Postcomm should adopt a more sophisticated approach to market definition that segments the market into licensed and non-licensed areas and includes services such as document exchange. This, it argued, will still show the extent of Royal Mail's monopoly but also demonstrate that end-to-end alternatives do exist.

A1.25. The MUA said it supported the intention to undertake a programme of visits and events aimed at raising customer awareness. The PPA believed there were two main reasons causing customer inertia: (a) the very limited coverage from alternatives, reducing opportunity and therefore interest for publishers, and (b) the considerable additional costs for publishers and mailing houses to manage split distribution. The PPA believed improving Royal Mail's customer service performance is an area to pursue with considerable urgency.

A1.26. TPG NV argued that, when attracting customers, instability is as bad as a monopoly and there were currently a number of examples of instability such as the proposal to introduce sized based pricing and zonal pricing.

A1.27. The DMA argued market awareness is a function of the level of competition in the market. Therefore if the level of competition is low, awareness will probably also be low. Although it said Postcomm's programme of visits and events is well intentioned, it argued Postcomm's resources would be better spent resolving market barrier problems such as VAT and developing the access code.

Other comments

A1.28. Royal Mail believed the prospects for entry are significantly greater than Postcomm believes and that barriers to entry are less significant (citing the example of the development of the access market). It argued that this, combined with its own expectation that customers will be more sensitive to price changes, meant that it was not possible to state that the provision of the universal service was guaranteed. It supported Postcomm's intent to monitor the development of the market carefully and to undertake regular competitive market reviews. Alongside this it believed it was essential that Postcomm has proactive policies to manage possible long term risks to the universal service. It also said that, when measuring competition, Postcomm must take into account the impact of the wider communications market and key sub-sectors within each market. For example the special delivery market has two distinct sub-sectors, a business sector which is highly competitive and an over the counter sector with limited competition; a decision for the whole market may not be appropriate for either sub-sector in isolation.

A1.29. Special Mail Services argued Royal Mail's quality of service is a barrier to entry and Postcomm should not pursue its policy of forcing increasing levels of quality on Royal Mail. It argued the quality of service targets do not reflect the needs of the market and must now undergo a fundamental overhaul. The PPA believed benchmarking of Royal Mail's account management is a part of Postcomm's remit and this should be applied to the overall aspects of Royal Mail's customer service as a matter of urgency.

A1.30. Amicus/CMA believed all operators should be subjected to the same quality of service standards as Royal Mail, with the results openly accessible within the public domain.

A1.31. The British Chambers of Commerce, and the Hull and Humber Chambers of Commerce urged Postcomm to work with Royal Mail and other potential service providers to set minimum standards for hours of delivery to ensure an adequate system of delivery is returned to businesses and to improve quality of service. The British Chambers of Commerce said Royal Mail's new single daily delivery had created a range of problems for businesses. It said Postcomm should ensure quality of service targets are met and problems of lost, delayed or mis-delivered mail are tackled. The second priority would be to ensure Royal Mail accepts in principle the need for early morning delivery. They argued the alternatives are currently very poor substitutes for early morning delivery. It asked Postcomm to keep this in mind when the next review of the universal service is undertaken. It also asked Postcomm to look into the apparent licence restrictions on Royal Mail preventing earlier deliveries. The British Chambers of Commerce also suggested two ways to improve the feedback mechanism to the regulators, the first of which is to have a Postwatch office in each of the Northern regions and, secondly, to have Royal Mail managers sitting on Chamber business committees around the UK to get in closer contact with businesses.

Annex 2 – Postcomm’s process for complaints of anti-competitive behaviour under Part 4 of Royal Mail’s licence

A2.1. Postcomm has powers to investigate anti-competitive behaviour by Royal Mail (there are provisions relating to accounting separation in Deutsche Post and TNT Mail’s licences, but these are only reporting requirements). Allegations that Royal Mail has behaved anti-competitively and which are received by Postcomm, and investigations which Postcomm carries out on its own initiative, will be subject to a two-stage process.

Stage One: Preliminary Assessment

A2.2. The aims of the preliminary assessment are to establish:

- o whether there is a potential case to investigate and, therefore sufficient reason to conduct a full investigation; and
- o whether, given the nature of any evidence supporting the complaint, a Provisional Order should be made.

A2.3. During the preliminary assessment stage, Postcomm would normally seek Royal Mail’s response to the allegations made and would respect complainant confidentiality wherever possible.

A2.4. Postcomm is also aware that it is not always possible for complainants to provide conclusive substantive evidence in support of their complaints. Therefore, where Postcomm thinks it necessary, it may also seek further information from other interested parties as well as Royal Mail (e.g. customers, operators and consumer groups) again respecting complainant confidentiality wherever possible.

A2.5. Upon completion of the preliminary assessment, Postcomm may decide that:

- o the complaint appears unfounded;
- o the allegations and the information supporting them do not merit a full investigation or do not merit a full investigation at the time in question;

- o there is a potential case to investigate and sufficient reason to conduct a full investigation;
- o there is a potential case to investigate and sufficient reason to conduct a full investigation and a Provisional Order should be made; or
- o the matter is best handled by referring it to the Office of Fair Trading (OFT) under the terms of the Memorandum of Understanding (MoU) between the two organisations.

A2.6. Under Section 23 of the Act, Postcomm must make a Provisional Order against Royal Mail if it appears that Royal Mail is contravening a licence condition and that a Provisional Order is needed.

A2.7. In deciding whether a Provisional Order is needed Postcomm shall have regard, in particular, to the extent to which any person is likely to sustain loss or damage as a result of anything likely to be done or omitted in contravention of the licence condition before a Final Order may be made.

A2.8. A Provisional Order has effect for three months, after which it may either lapse or be confirmed as a Final Order. A Provisional Order may also be made, if justified, at any subsequent stage in this process.

Stage Two: Full Investigation

A2.9. At the start of a full investigation, Postcomm will publish on its website a document setting out the scope of its investigation.

A2.10. A full investigation involves the collection of information and an assessment of whether any of Conditions 9 – 13 in Part 4 of Royal Mail’s licence have been breached. Postcomm will collect evidence from all the main parties to the complaint. Postcomm may also seek further evidence from other parties, including customers of either the complainant, or Royal Mail. In most instances, Postcomm will use its formal powers under Section 47 of the Act, or Condition 16 of Royal Mail’s licence, to collect evidence.

A2.11. Once Postcomm has collected all the evidence required, it will assess whether there has been any breach of Conditions 9 – 13.

A2.12. If Postcomm considers that Royal Mail has engaged in behaviour prohibited by Conditions 9-13, it may (depending on the circumstances) take the following action against Royal Mail:

- o a Final Order under Section 22 of the PSA 2000;
- o a Provisional Order under Section 23 of the PSA 2000; and/or
- o impose a financial penalty under Section 30 of the PSA 2000.

A2.13. In some instances, where appropriate, the matter may be settled through Royal Mail providing Postcomm with suitable assurances (i.e. through the provision of undertakings).

A2.14. Whether Postcomm takes action or not, or judges that Royal Mail has not engaged in behaviour prohibited by Conditions 9-13, it will publish its findings or otherwise explain its decision.